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OPPORTUNITIES IN PRIVATE CREDIT

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Investors have been piling into private credit over the past five years. Initially lured by the potential of higher returns relative to liquid credit investments and floating rate structures that can act as a hedge to rising interest rates, private credit has now become a growing part of many investors' portfolios. According to the Coller Global Private Equity Barometer Summer 2024,[1] 44% of all global investors surveyed expected to increase their allocation to private credit. Despite being impacted by the broad slowdown in private market fundraising, private credit has grown to be a $1.7 trillion industry, with most of the capital in senior loans or traditional direct lending.[2]

However, direct lending is only one area where investors can take advantage of opportunities in private credit. Given the growth of direct lending assets, driven in part by the proliferation of perpetual or evergreen strategies that need to continuously deploy capital, we have seen an ever-increasing competitive environment in the direct lending space. In addition, the broadly syndicated loan market has seen activity pick up again and is another competitor for deal flow. According to the Pitchbook/LCD data, syndicated loan activity increased to $958.8 billion in the first three quarters of 2024, up from $283.5 billion in the first three quarters of 2023.[3] The amount of capital being deployed for senior and unitranche credit opportunities has resulted in tightening credit spreads, with 17% of the deals in the first half of 2024 seeing spreads within 500 bps of SOFR, compared to none in the second half of last year.[4]

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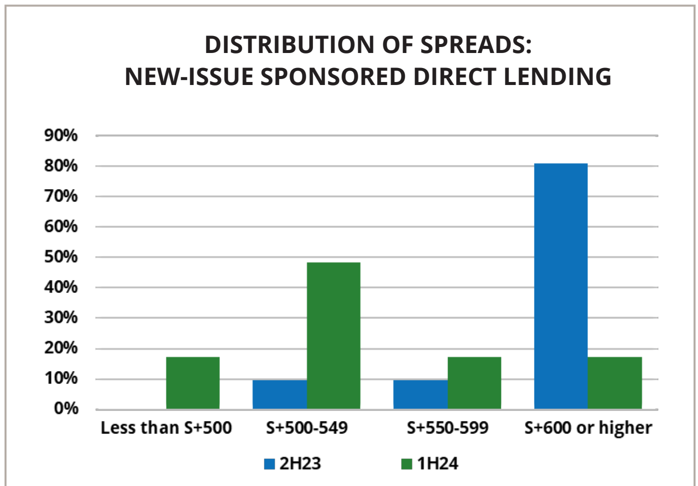
We are seeing some issues in the direct lending environment, including Vista's recent default on its PluralSight investment.[5] However, despite these issues and the spread compression we are seeing in the direct lending market, we still feel that direct lending is an attractive place to deploy capital with the right managers. Even some lenders in PluralSight will make out just fine. But given this ever-tightening spreads environment and the potential for more choppy roads ahead, we feel that it makes sense for investors to look outside of senior direct lending when it comes to their private credit portfolios.

Senior corporate loans make up only part of a broader credit market. In this article, we discuss three areas where investors might want to look to diversify their private credit exposure. Two of those areas exist in the Asset Backed Finance space, which we will discuss below and the third takes advantage of structural and technical opportunities in the broadly syndicated loan market.



Source: PitchBook | LCD • Data through June 30, 2024
Data based on LCD News reporting; reflects spreads on senior secured loans and unitranches.

ASSET BACKED FINANCINGS

According to estimates from Apollo, the Asset Backed Finance market is over a $20 trillion market today.[6] The pull back in bank lending has created opportunities for more private credit strategies than just corporate direct lending. This shift away from bank lending comes at a time when demand for credit continues to grow. Corporations still need to finance equipment and receivables and consumers still need to finance mortgages and auto loans. Asset Backed Financing is when a loan is supported by the contractual cash flows from a pool of assets, while the assets are also used as collateral for the loan. These assets could be homes or buildings, in the case of residential or commercial real estate loans, a pool of consumer finance assets, such as auto loans or credit card receivables or "mission-critical" hard assets, such as school buses or manufacturing equipment.

Asset Backed Financings have a number of characteristics that make them unique, and potentially less risky, than traditional corporate credit. These characteristics can vary depending on the asset being financed.

The main areas of Asset Backed Financings include

1. Residential Mortgage Loans
2. Consumer Finance
3. Commercial Real Estate
4. Hard Assets
5. Financial Assets (including royalties)

While each area has its own unique characteristics and attractive opportunities today, we will focus on the last two areas for this discussion—hard asset lending and royalties.

HARD ASSET LENDING

Hard asset lending is an area that banks traditionally played in. Borrowers can use "mission-critical" assets as collateral for loans or leases, freeing up working capital for other business needs. These assets can range from data centers to manufacturing equipment, and school buses to existing inventory. Essentially, any hard asset that is important to an operating business.

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There are a number of characteristics that often make hard asset loans less risky than senior corporate loans of lenders. These include:

1. Hard asset loans are usually self-liquidating while principal is not usually paid until the end of the term of the loan. This amortization derisks the loan over time as less principal is at risk.

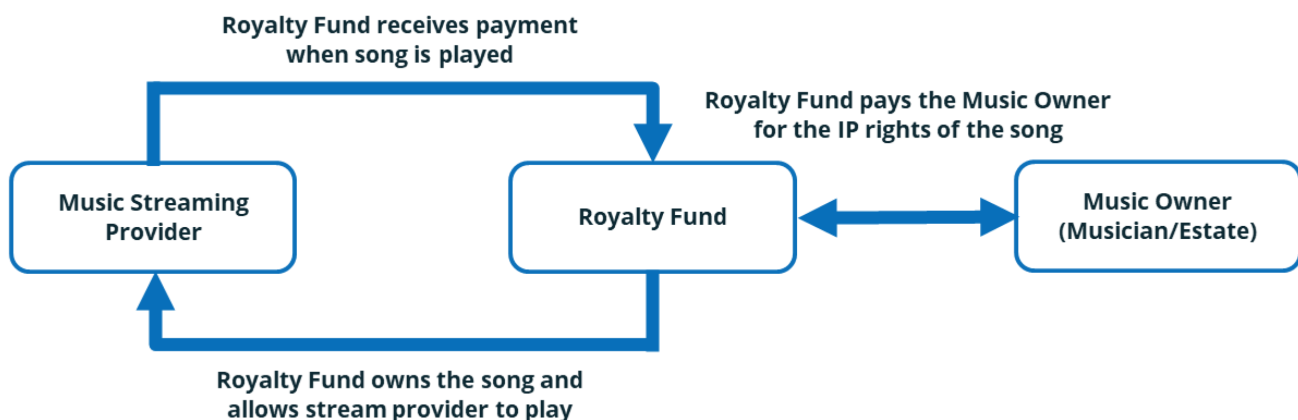
2. These loans are often secured by pools of assets that are "mission-critical" to the operations of a company. If the borrower defaults on the loan, the lender can take possession of the asset and resell to cover the default. These assets can be worth more than the underlying loan. Additionally, the value of some assets can rise in an inflationary environment, creating a natural hedge to inflation risk.

The hard asset lending market is fragmented, and loans are usually smaller than middle market direct lending deals. Banks have traditionally been the main source of hard asset financing, but, as with other markets, they have pulled back. This has opened up an opportunity for private credit funds with expertise in hard asset lending to step in and fill the capital void. Because the size of the deals are typically smaller, competition for those deals tends to be small, as deals are both difficult to source and too small for larger funds. As a result, for well-connected private credit funds, there is an opportunity to earn higher returns for a similar level of risk when compared to typical middle market direct loans. However, it's not easy to effectively underwrite hard asset loans. Finding attractive investments requires a thorough review of the borrower and the underlying assets used to collateralize the loan, as well as the deal structure. Therefore, while there are attractive opportunities in the hard asset lending space, it is important to partner with the right manager.

ROYALTY FUNDS

A royalty is another example of asset backed financing. It is a payment to the owner of an asset for its ongoing use from a company. Examples of common royalty payments include music royalties, where the person who uses a song, such as a streaming music service like Spotify and a producer of video content that uses the song in a video, pays the owner of the intellectual property rights to the song. In the case of music, that has traditionally been either the music producer or songwriter. Today, investors in the form of royalty funds are some of the largest owners of music rights. The fund buys the music rights from the owner in exchange for a large cash payment.

Below is an example of how a music royalty is structured:



Today, some estimates peg the royalty market size at over $2 trillion and royalty sectors extend well beyond music. While music royalties might be one of the more well-known sectors, royalties have had a long track record in energy, mining, and pharmaceuticals sectors. The table on the following page highlights the traditional royalty sectors and their expected lives.

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SECTOR	ENERGY	MUSIC	PHARMACEUTICALS	MINING
ASSET	Mineral rights to land where oil or gas production is taking place	Master and publishing rights to a song or library of songs	Intellectual property or licensing right to pharm product	Royalty interest in production from mining operations
REVENUE STREAM	Paid a percentage of the production from well operator	Paid a fee when song is played	Paid a percentage of revenue when strong is sold	Paid a percentage of production from mine operator
EXPECTED LIFE	Over 25 years	Over 50 years	10-15 years	Over 20 years

Source: Clearstead estimates, Partners Group.

As you can see, some of these assets have the potential to have long lives. The payments can vary and do depend on the underlying performance of the asset. Therefore, it is important to invest in assets with a more stable demand or return profile. The structure of the royalty can also help mitigate the downside risk. However, unlike traditional fixed income, the royalties also have the ability to participate in the upside of an investment if the asset outperforms or provides inflation protection when prices increase.

Just about anything with a future cash flow can be converted into a royalty. Rapidly growing areas of investors' interest include sectors such as carbon offset, sport (both IP rights to team brands and broadcasting rights), name image and likeness rights to a person (such as an athlete or artist), and consumer and retail brands.

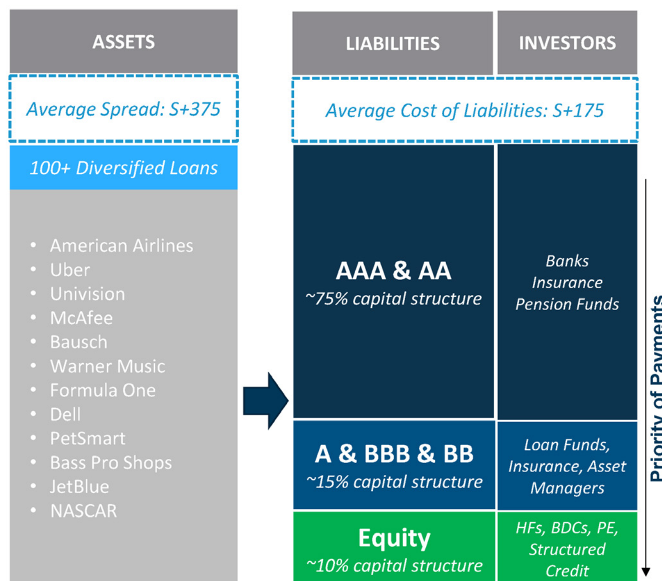
Once again, it is important to partner with the right managers when it comes to investing in royalties. The manager needs to understand the quality of the underlying asset and create a structure to maximize returns while minimizing potential losses. With the right manager, there is the opportunity to generate a stable cash yield, in an asset class that has minimal correlation to an existing fixed income portfolio.

COLLATERALIZED LOAN OBLIGATIONS

Collateralized Loan Obligations (CLO) are different from the Asset Backed Financings that we previously discussed. Instead of a loan or cash flow stream backed by an underlying asset, a CLO is a stream of cash flows backed by a pool of syndicated senior secured bank loans. Typically, these are loans to larger companies with $100MM+ in earnings. Since these are loans to corporations, they have many of the same characteristics of a private direct lending loan, including floating interest rate (usually tied to SOFR plus a spread) and a senior place in the capital structure, which should lead to higher recovery rates. However, the competitive dynamics in the direct lending space also exist in the broadly syndicated markets since they do compete for assets, after all. Those issues include no or light covenants, which can in turn lead to lower recoveries and competitive pricing.

CLOs are a pool of actively-managed syndicated loans, and typically include 100-200+ loans. The CLO is divided into tranches, similar to other collateral debt pools, where a waterfall of payments is created (see chart on the right).

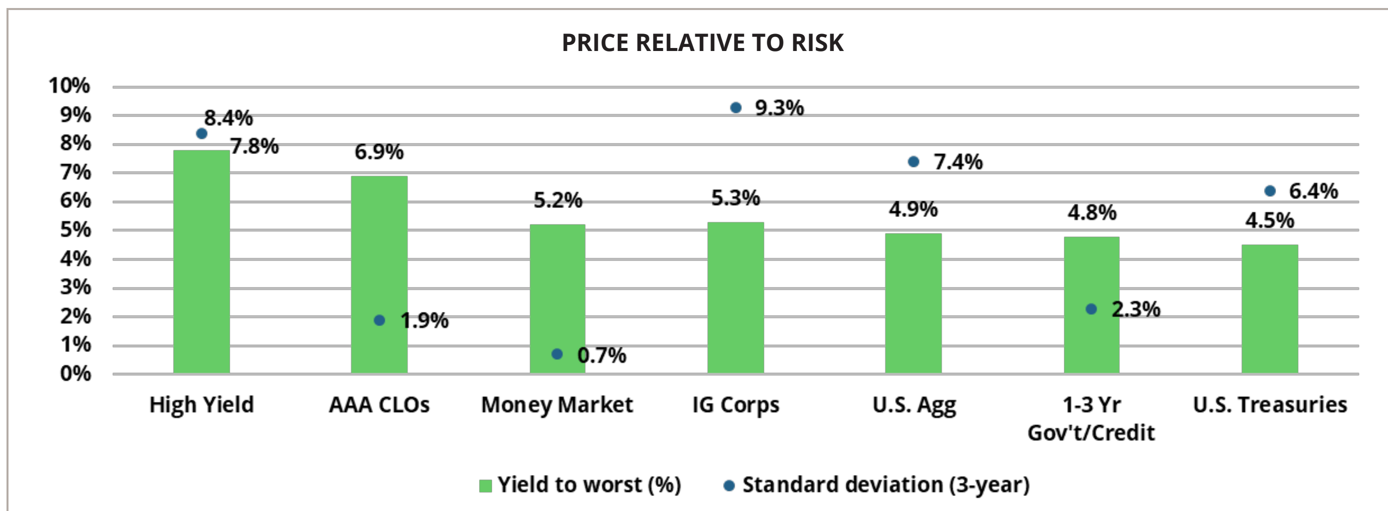
SAMPLE CLO STRUCTURE



Source: Onex.

The top tranche has priority of payments, followed by the second tranche and all the way down to the final tranche which is the equity tranche and takes the remaining residual value. Because the senior tranches are paid first, they have the lowest expected return, while the junior tranches have higher expected returns.

It is the diversification and active management of these pools that lead to investments with a lower risk of default or losses compared to other credit investments or corporate borrowers. According to data from Moody's, CLO tranches have experienced 27 cumulative defaults between 1993–2023—a period which includes the Global Financial Crisis—out of over 31,000 CLO tranches that were part of the dataset.[7] The historical cumulative default rates of BBB CLOs has been 0.3%, compared to 1.6% for BBB corporates. Despite this lower risk profile, CLOs trade at attractive prices relative to other fixed income and credit investment, with AAA CLO tranches generating returns not too far from high yield debt, with substantially lower risk.



Source: Bloomberg, JPMorgan, Morningstar. Data as of June 30, 2024,[8]

There are many ways that investors can take advantage of the pricing anomalies in the CLO market. There are both liquid and private credit strategies that can capture these return premiums, with private credit opportunistic CLO funds looking to garner returns in the mid-teens. Like the other strategies we have discussed, it is important to select the right manager to mitigate the risks and generate optimal risk-adjusted returns.

CONCLUSION

There is more to credit than just middle market direct lending. At times, those areas might even offer better risk-adjusted returns, and they can offer diversification to a portfolio. However, it is important to understand the risks and to select quality managers to implement the strategies. A knowledgeable and experienced team in both credit and private markets, like the team at Clearstead, can help navigate this diverse opportunity set.

Source:

(1) https://www.collercapital.com/wp-content/uploads/2024/06/Coller-Capital-Global-Private-Equity-Barometer-Summer-2024_Digital.pdf
(2) https://www.mckinsey.com/industries/private-capital/our-insights/mckinseys-private-markets-annual-reviewl
(3) Pitchbook LCD Q3 2024 US Credit Markets Quarterly Wrap
(4) Pitchbook LCD US Private Credit & Middle Market Quarterly Wrap 30 June 2024
(5) https://www.wsj.com/articles/vista-equitys-pluralsight-to-cede-control-to-private-lenders-fed39cde
(6) https://www.apollo.com/institutional/insights-news/insights/2023/10/asset-backed-finance-the-next-evolution-of-private-credit
(7) Moody's Investor Service Cumulative Loss Rate Data, published May 2023
(8) Indices used to represent asset classes: High Yield (Bloomberg U.S. Corporate High Yield Index), AAA CLOs (JP Morgan AAA CLO Index), IG corporates (Bloomberg U.S. Corporate Investment Grade Index), Money Market (S&P U.S. Treasury Bill 0-3 Month Index), Agg (Bloomberg U.S. Aggregate Bond Index), 1-3 Yr Gov/Cr. (Bloomberg 1-3 Year U.S. Gov/Credit Index), U.S. Treasuries (Bloomberg U.S. Treasuries Index)

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

September 30, 2024		1M	3M	12M	YTD
US Large Cap	S&P 500 Index	2.1%	5.9%	36.4%	22.1%
US Small Cap	Russell 2000 Index	0.7%	9.3%	26.8%	11.2%
Developed Intl	MSCI EAFE (Net)	0.9%	7.3%	24.8%	13.0%
Emerging Intl	MSCI Emerging Markets (Net)	6.7%	8.7%	26.1%	16.9%
Real Estate	FTSE NAREIT All REITs Index	3.0%	16.2%	33.7%	13.7%
Core Fixed	Blmbg. U.S. Aggregate Index	1.3%	5.2%	11.6%	4.4%
Short Fixed	Blmbg. 1-3 Year Gov/Credit index	0.8%	3.0%	7.2%	4.4%
Long Fixed	Blmbg. U.S. Long Government/Credit	2.3%	8.0%	17.2%	3.5%
Corp Debt	Blmbg. U.S. Credit Index	1.7%	5.7%	13.8%	5.2%

Source: Bloomberg

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